United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-4227

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For the Second Circuit

Edwin C. Whitehead and
Josephine Whitehead,

Appellants,

—against—

Commissioner of Internal Revenue,

Appellee.

ON APPEAL FROM THE UNITED STATES
TAX COURT

BRIEF ON BEHALF OF APPELLANTS

Roberts & Holland
Attorneys for Appellants
1301 Avenue of the Americas
New York, New York 10019

Of Counsel:

Laurence Goldfein
Mark H. Johnson
Richard A. Levine
Lary S. Wolf

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APPELLANTS' BRIEF

PRELIMINARY STATEMENT

These proceedings involve deficiencies of income tax for the calendar year 1966. The trial was held on June 21, 1973, in New York, New York before Judge Wiles of the United States Tax Court. His Findings of Fact and Opinion dated April 17, 1975 are reported at 64 T.C. No. 7.

On July 17, 1975 formal decisions finding deficiencies against the respective appellants were entered. A Notice of Appeal to this Court was duly and timely filed on October 6, 1975.

The deficiencies relevant herein were based on section 1248 of the Internal Revenue Code*, which provides that gain realized on the sale or exchange of stock in a "con-

* Hereinafter, section references in this brief, unless otherwise noted, are to the Internal Revenue Code of 1954, as amended (the "Code").

trolled foreign corporation" (as defined in section 957(a)) is taxed as a dividend. A "controlled foreign corporation" is defined by section 957(a) to mean "any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned . . . by United States shareholders . . ." (Emphasis supplied).

In 1966, Edwin C. Whitehead (hereinafter referred to as "Whitehead") and Edwin C. Weiskopf (hereinafter referred to as "Weiskopf") disposed of their interest in Ininco, Ltd. (hereinafter referred to as "Ininco"), a United Kingdom corporation. The Commissioner determined this disposition to be subject to Section 1248, contending that Ininco was a "controlled foreign corporation". The Tax Court upheld the Commissioner's determination.

QUESTIONS PRESENTED

1. Whether Ininco was a "controlled foreign corporation" within the meaning of section 957 of the Internal Revenue Code.

2. If it is, whether the sale by Weiskopf and Whitehead of their interest in Ininco should be treated for tax purposes as if they liquidated Ininco.

STATEMENT OF FACTS

During the years relevant to this proceeding, Technicon Instruments Corporation ("Technicon"), a New York corporation, was wholly-owned by Weiskopf and Whitehead. Technicon's business started in 1939 and in 1957 Technicon began manufacturing and distributing, principally in the United

States, a patented machine known as the "AutoAnalyzer".

Technicon maintained manufacturing facilities in England and manufacturing was done there by Technicon's wholly-owned subsidiary, Technicon Instruments Company, Ltd. ("Limited"). (Stip. Par. 11, App. 39A.) William Robert Carr ("Carr"), one of the directors of Limited, acted as Limited's solicitor from the time of its incorporation. At about the time Technicon sought to expand the manufacturing capabilities of Limited in 1963, Carr proposed that an Overseas Trade Corporation be created under United Kingdom law in order to gain the tax deferral afforded to Overseas Trade Corporations by United Kingdom legislation. Under that legislation, an Overseas Trade Corporation could defer United Kingdom income and profits taxes on its trading income from sales outside the United Kingdom. (Stip. Par. 9, App. 38A.)

Carr advised Whitehead and Weiskopf of various requirements that would have to be met for a corporation to qualify as an Overseas Trade Corporation. Carr also advised that the provisions of the United Kingdom law denied Overseas Trade Corporation benefits to a company that was subject to a "surtax direction." Under the United Kingdom provisions, a corporation may be subject to a surtax direction if it is controlled by five or fewer persons. The effect of a surtax direction is to tax the profits of the company as if the profits had been distributed to the shareholders. (App. 158A, 159A.)

Carr explained to Whitehead and Weiskopf that an

exemption from the surtax direction provisions applied, however, if the corporation's shares were held by a public company quoted on a recognized stock exchange. To avoid the problem of a surtax direction and thereby gain the benefits of Overseas Trade Corporation tax deferral, Carr recommended that at least 50 percent of the voting power of Ininco be owned by a United Kingdom corporation which was quoted on a recognized stock exchange. (App. 160A.)

Weiskopf and Whitehead asked Carr to try to find an investor that would meet the above requirements. (App. 161A, 162A.) After approaching several potential investors who were not interested, Carr approached Bernard Franklin ("Franklin"), who was on the Board of Directors of Unex Investment Trust, Ltd. ("Unex"), a publicly held corporation traded on the London Stock Exchange, and of Unex's subsidiary, Romney Finance Company, Ltd. ("Romney"), which was formed to acquire investments in private companies. Franklin expressed interest, on behalf of these companies, in investing as a preferred stockholder of the proposed Overseas Trade Corporation. (App. 106A, 107A, 161A, 162A.)

Franklin's interest sparked a series of arm's-length negotiations between Carr, who was acting for Whitehead and Weiskopf, and Franklin, who was acting for Romney and Unex. (App. 107A - 110A.) During these negotiations, Franklin insisted on a dividend of 12-1/2 percent, which was substantially higher than the prevailing rate for good risk loans, and he rejected the 8 percent to 9 percent dividend first offered by

Whitehead and Weiskopf. (App. 108A, 139A.) Romney eventually received the 12-1/2 percent dividend that Franklin wanted.

Franklin also wanted Romney to have sufficient rights to protect its interest and to safeguard its investment. For this reason he regarded 50 percent voting power as fundamental. He would not have made the investment in Ininco's shares unless Romney received 50 percent of the voting power, including power to appoint one-half of the directors of Ininco. (App. 109A.)

Weiskopf and Whitehead were reluctant to give 50 percent of the voting rights in Ininco to an unrelated company over which they could exercise no control. Since the incorporation of Technicon, almost 30 years before, Weiskopf and Whitehead had operated all of the Technicon companies without the participation of outside investors. (App. 56A, 57A, 85A - 90A.) One of their major concerns was that, if a disagreement arose, Romney, with equal voting rights, could effectively tie up the capital and the operations of Ininco. They were also concerned that, as Americans doing business in England with a publicly held listed British corporation, they would be at a disadvantage in the event of a dispute. (App. 57A, 85A - 90A.) Despite their fears and because they wished to get the Overseas Trade Corporation benefits available under United Kingdom law, Weiskopf and Whitehead offered Romney 50 percent of the voting rights in the Overseas Trade Corporation to be formed. (App. 56A.)

Ininco then was incorporated under the laws of the United Kingdom on November 28, 1963. It was established and

did qualify as an Overseas Trade Corporation under United Kingdom law, and as a result United Kingdom income and profits tax on Ininco's trading income from outside the United Kingdom was deferred. (Stip. Par. 9, App. 38A; App. 52A, 152A, 153A.)

The share capital of Ininco was divided into three classes of stock as follows: (a) 250 Preferred Ordinary Shares of 100 pounds each; (b) 250 Deferred Ordinary Shares of 10 pounds each; and (c) 175 Second Preferred Ordinary Shares of 100 pounds each. The Articles of Association of Ininco provided that the Preferred Ordinary Shares and the Deferred Ordinary Shares were entitled to one vote per share and that a majority of each such class of stock was entitled to appoint not more than two of the directors of Ininco. The Second Preferred Ordinary shares had no voting rights. (Stip. Par. 10, App. 38A - 39A; Ex. 10-J.)

Upon the incorporation of Ininco, Romney acquired all of the 250 Preferred Ordinary Shares of Ininco, for which it paid 25,000 pounds. Intapco, Inc. ("Intapco"), a domestic corporation owned by Weiskopf and Whitehead and formed by them to facilitate their participation in Ininco, acquired all of the 250 Deferred Ordinary shares and all of the 175 Second Preferred Ordinary Shares of Ininco, for which it paid 2,500 pounds and 17,500 pounds, respectively. (Stip. Par. 10, App. 38A - 39A.)

Commencing at the end of 1963, Ininco engaged in the business of selling, outside the United States and the

United Kingdom, AutoAnalyzers manufactured by Limited. Limited continued to sell AutoAnalyzers it manufactured to customers in the United Kingdom and certain British Commonwealth countries. (App. 53A, 54A, 72A.) Ininco maintained an office in Holland. (App. 67A, 98A, 99A, 157A; Ex. 23-W, App. 219A.) It did not maintain office facilities in England, and to the extent office facilities were needed by Ininco for its operations in England, Limited's offices in England were available. (App. 67A, 68A.)

There was never any agreement or understanding, either written or oral, between Whitehead or Weiskopf or any of their agents or any entity owned by them, on the one hand, and Franklin or Romney or Unex, on the other hand: (a) regarding how Romney would vote its shares in Ininco or how Romney should exercise its voting rights, (b) that Romney would vote its shares in Ininco in accordance with instructions from Whitehead, Weiskopf, Technicon or any entity owned by any of them or person designated by them; or (c) that Romney would or would not exercise its voting rights or would exercise them in a certain way. (App. 57A - 59A, 111A, 112A, 168A, 169A.) It was always understood by Romney and Intapco that Romney would exercise its voting rights freely in a manner designed to protect its interests and the interests of Ininco. (App. 58A, 59A, 112A.)

During the discussions between Carr, Whitehead and Franklin regarding the organization of Ininco, there was never any discussion regarding any possible United States tax conse-

quences nor did any United States tax consequences play any part in deciding on the corporate structure or capital structure of Ininco. Weiskopf and Whitehead had no United States tax considerations in the formation of Ininco or in offering Romney 50 percent of the voting rights in Ininco. (App. 57A, 83A, 84A, 120A, 162A.) Liquidation of Ininco was in no way contemplated when the corporation was created; Ininco was intended to be a permanent fixture and the parties expected their investment to be long-term. (App. 110A, 113A, 161A.)

The Board of Directors of Ininco consisted of four directors: two directors appointed by Romney and two directors appointed by Intapco. Romney, as owner of the Preferred Ordinary Shares, and Intapco as owner of the Deferred Ordinary Shares, each had the right, pursuant to the Articles of Association of Ininco, to appoint or replace their respective two directors by simply giving notice to Ininco. (Ex. 10-J, page 26, par. 84.) During the period November 29, 1963 to March 14, 1966 the directors of Ininco were Edwin C. Whitehead and Edwin C. Weiskopf, who were appointed by Intapco, and Bernard Franklin and Maurice Goldwater, who were appointed by Romney (App. 110A, Stip. Par. 29, App. 46A; Ex. 22-V, App. 216A.)

During the period 1963 to 1966 several meetings of the Board of Directors of Ininco were held either at the offices of Carr's firm, E. F. Turner & Sons, or at Franklin's office. Romney was represented by Franklin and Goldwater at

such meetings. Intapco was represented at two such meetings by Whitehead. At other meetings Intapco was represented by Leslie James Evans ("Evans") who was an alternate director to Whitehead. (Exs. 10-J; 13-M; 14-N; 21-U, App. 213A; 22-V, App. 216A; 23-W, App. 219A; 24-X, App. 220A; 25-Y, App. 221A; 26-Z, App. 222A; 27-AA, App. 225A; App. 133A.) Evans, the managing director of Limited, was the Secretary of Ininco and performed the function of managing director (President) of Ininco, although he did not hold that office. (Exs. 21-U, App. 213A; 22-V, App. 216A; 23-W, App. 219A; App. 66A, 67A.)

In addition to meetings of the Board of Directors, Franklin attended informal meetings from time to time with Evans to review financial matters relating to Ininco. (App. 133A.) Franklin did not become involved in the day-to-day management of Ininco. (App. 112A - 113A.)

There was no provision in the Articles of Incorporation of Ininco to break any deadlocked vote which might arise. (App. 109A, 162A - 164A.) Accordingly, a deadlock vote would have brought Ininco to a standstill. However, during the existence of Ininco, no deadlock situations actually arose.

At the time Intapco and Romney acquired shares in Ininco, they entered into a Shareholders' Agreement dated November 29, 1963. Article 3 of that agreement provided, in effect, that if Intapco desired to dispose of its Ininco shares, it must first offer the shares for sale to Romney, and vice versa. If the shares offered were not purchased by the other stockholder, the offering shareholder was free to sell the

shares or could call for liquidation of Ininco. Under the Shareholders' Agreement the price to be paid to the selling shareholder for the offered shares was the amount which the shares would receive on liquidation of the corporation, taking into account the corporation's tax liabiities. (Ex. 14-N, Arts. 3, 4, 5, and 6, App. 205A - 211A.) Upon liquidation, the owners of the Preferred Ordinary Shares and the Second Preferred Ordinary Shares were entitled to receive the par value of those shares, plus unpaid dividends, if any. The balance, if any, was distributable to the Deferred Ordinary Shares. (App. 171A, 172A, 173A; Ex. 10-J.)

The Shareholders' Agreement also provided that in view of the even division of control of Ininco between the holders of the Preferred Ordinary Shares and the Deferred Ordinary Shares, the parties in their capacity as shareholders and directors would endeavor to prevent a deadlock that would impede the normal conduct of the business of the company, and would exercise all due diligence to resolve any such impasses expeditiously. (Ex. 14-N, Art. 9, App. 211A.) Any dispute arising under the Shareholders' Agreement was required to be settled by arbitration. (Ex. 14-N, Art. 13, App. 212A.)

The special treatment accorded by the United Kingdom to Overseas Trade Corporations was abolished by legislation enacted in 1965 and effective as of April 6, 1966. That legislation first came to public attention on or about April 6, 1965,

when the British Parliament issued the Finance Act of 1965, which was to take effect on April 6, 1966. (Stip. Par. 18, App. 40A; App. 161A.) Carr advised Whitehead and Weiskopf of this new legislation and that, as a result, Ininco would no longer be able to defer income and profits taxes on its current income. (App. 169A, 170A.) Upon receipt of such advice from Carr, Weiskopf and Whitehead decided they would like to dispose of their interests in Ininco. (App. 60A, 170A.)

Carr advised that if Ininco were liquidated its accumulated profits would bear United Kingdom tax at the rate of about 40 percent. Therefore, he suggested that Weiskopf and Whitehead should instead sell their shares of Intapco to a Hong Kong corporation in order to minimize the impact of United Kingdom income tax. (App. 171A, 172A, 173A.)

Carr worked out a plan for the sale of all of the shares of Ininco owned by Intapco and Romney to Hong Kong Holdings Limited ("Hong Kong Holdings"), a Hong Kong corporation. Carr contacted Hong Kong Holdings and conducted the negotiations with them. The purpose of this plan was to allow Weiskopf and Whitehead to realize on their investment without the United Kingdom imposing a tax on the previously deferred earnings of Ininco. (App. 171A, 172A.) In anticipation of a possible sale by Weiskopf and Whitehead of their shares in Intapco to Hong Kong Holdings, Weiskopf, Whitehead and Intapco entered into an agreement whereby Weiskopf exercised an option to obtain one-half

of the common stock of Intapco in exchange for some of his Intapco preferred stock, such conversion to be effective upon the execution of an agreement with Hong Kong Holdings. (Ex. 9-I.)

Carr then contacted Franklin and advised him of Weiskopf's and Whitehead's wishes, and asked if Romney would agree to sell its shares in Ininco. (App. 113A, 135A, 170A.) Franklin at first was indignant at Carr's suggestion. He objected because Romney's investment in Ininco was to have been a long term investment. (App. 113A, 136A; Ex. 38, App. 231A.) However, after reflecting that the impetus for disposing of the Ininco shares was the repeal of the Overseas Trade Corporation law, Franklin decided that Romney should not offer an impediment to the sale of the Ininco shares. Franklin understood the predicament of Weiskopf and Whitehead, and Romney agreed to sell its Ininco shares. (App. 113A, 114A, 139A.)

Franklin insisted that under the circumstances Romney should receive a premium over and above what it was entitled to receive on liquidation (<u>i.e.</u> a premium in addition to its accrued dividend and the par value of its shares). (App. 114A; Ex. 38, App. 231A.) It was agreed that Romney would receive a premium, which was paid in the form of an additional dividend to Romney on its preferred shares. (App. 114A; Ex. 26-Z, App. 222A.)

Pursuant to an agreement of sale between Weiskopf and Whitehead and Hong Kong Holdings dated February 21, 1966, Weiskopf sold 50 shares of common stock of Intapco and 440 shares of preferred stock of Intapco to Hong Kong Holdings and

Whitehead sold 50 shares of common stock of Intapco to Hong Kong Holdings. (Ex. 20-T.) The total amount received by Whitehead for his stock in Intapco was $1,100,654.16. The total amount received by Weiskopf for his stock in Intapco was $1,155,220.17. (Stip. Par. 23, App. 42A.) Romney also sold its shares in Ininco to Hong Kong Holdings, and received an amount equal to the par value of those shares plus accrued dividends at 12-1/2 percent and a 900 pound premium dividend. (Exs. 20-T; 26-Z, App. 222A; 27-AA, App. 225A; 38, App. 213A.)

Hong Kong Holdings was, at the time of this sale, a subsidiary of Wheelock Marden, a major Hong Kong corporation. (App. 171A.) Apart from the sales of shares described above, there were no financial interests or dealings at any time between Hong Kong Holdings and Whitehead, Weiskopf, Technicon or any Technicon affiliate or subsidiary. (App. 61A.) Apart from such sales, there were no financial interests or dealings at any time between Hong Kong Holdings and Franklin, Romney, Unex, or any Unex or Romney affiliate or subsidiary. (App. 135A.)

Weiskopf and Whitehead each reported the gain on the sale of his Intapco shares on his federal income tax returns for the calendar year 1966 as long-term capital gain. (Exs. 1-A, 2-B.)

ARGUMENT

Point I

Ininco Was Not a Controlled Foreign Corporation Because Not More Than 50 Percent of the Total Combined Voting Power of All Classes of Stock Entitled to Vote Was Owned by United States Shareholders

A. General Statement

In 1966 Weiskopf and Whitehead (hereinafter some-

times referred to as "Appellants") sold their stock in Intapco, Inc., a New York corporation wholly owned by them, to Hong Kong Holdings Ltd. Intapco, whose sole asset was shares of stock in Ininco, had been formed principally for the holding of stock in Ininco, a corporation organized under the laws of the United Kingdom. Appellants reported their gain on the sale of the Intapco stock as long-term capital gain. The Tax Court upheld the Commissioner's assertion that their gain should be taxed under the provisions of section 1248.

The statutory scheme set forth in section 1248 is quite complicated. Summarily stated, the section covers a sale or exchange of stock in a "controlled foreign corporation" (as defined in section 957(a)) by a United States person who owns (after applying the rules for determining stock ownership set forth in section 958) 10 percent or more of the total combined voting power of all classes of stock of such foreign corporation entitled to vote. The tax effect of applying section 1248 is that the gain realized on the sale or exchange of stock is taxed as a dividend, subject to the limitations set forth in section 1248(b).

Under section 1248(e), the sale or exchange of stock in a domestic corporation formed or availed of principally for the holding of stock in a foreign corporation is treated as a sale or exchange of stock of the foreign corporation. Since Intapco was formed principally for the holding of stock in Ininco, and since Weiskopf and Whitehead were United States

persons who indirectly owned, under the ownership rules of section 958, 10 percent or more of the total combined voting power of Ininco, the applicability of section 1248 in this case turns on whether Ininco was a "controlled foreign corporation" as defined in section 957(a).

Under section 957(a), more than 50 percent of the total combined voting power of all classes of stock entitled to vote must be owned by United States shareholders in order for a corporation to be considered a "controlled foreign corporation". The issue presented to this Court for consideration here is whether, notwithstanding the equal division of all voting rights in Ininco between Appellants, the United States shareholders, and Romney, the non-United States shareholder, Ininco should be considered a "controlled foreign corporation".

In two recent decisions, Garlock, Inc. v. Commissioner, 489 F.2d 197 (2d Cir. 1973), cert. denied 417 U.S. 911 (1974); and Kraus v. Commissioner, 490 F.2d 898 (2d Cir. 1974), this Court ruled that the equal division of stockholder voting power was not, per se, sufficient to avoid "controlled foreign corporation" status, where other factors demonstrated that voting power owned by the non-United States shareholders was not "real" and "meaningful." Appellants do not propose to challenge the rationale of these decisions. The opinions in those cases emphasized the controlling reality of the voting power, and deprecated formalities motivated by tax avoidance. This case, however, stands

secure on such an interpretation. The facts in this case amply demonstrate that the most enveloping application of the statute and regulations would not result in Ininco being considered a "controlled foreign corporation."

This brief will first analyze the facts of this case in terms of the voting power tests set forth in the statute and Treasury regulations and in the Court's opinions in Garlock and Kraus. It will then analyze the Tax Court's misapplication of these tests to this case.

B. Romney had 50 percent of the voting power and its voting rights in all respects equalled Appellants' voting rights.

Section 957(a) defines a "controlled foreign corporation" to mean:

> ". . . any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation." (Emphasis supplied)

Since Weiskopf and Whitehead were the only United States shareholders of Ininco, it must be shown that more than 50 percent of the total combined voting power of Ininco was "owned" by them. Congress clearly intended the test to be one of stockholder voting power and nothing else. There is no basis in the statute, its legislative history, the case law or the Treasury's own regulations to support the imposition of an ex-

panded definition of a "controlled foreign corporation" which injects esoteric notions of control.

The Treasury has promulgated regulations (Treas. Reg. §1.957-1(b)) which elaborate on the voting power test for "controlled foreign corporation" status set forth in the statute. Yet, it is clear that under the various tests set forth in the regulations, Ininco was not a "controlled foreign corporation".

Whitehead and Weiskopf, through Intapco, had none of the powers listed in Treas. Reg. §1.957-1(b)(1)(i), (ii) and (iii) since (1) Intapco could not elect, appoint or replace a majority of the Board of Directors of Ininco; (2) in the event of a deadlock vote Intapco could not break the deadlock by casting the deciding vote; and (3) Intapco could not appoint, elect or replace any person or officer who could exercise the powers of the Board of Directors. On all of these points, there was an equal division of power between Appellants, on the one hand, and Romney on the other.

Treas. Reg. §1.957-1(b)(2) states as a general proposition that "[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." Various instances are then enumerated where "[t]he mere ownership of stock entitled to vote" may not be given effect.

First, "if there is any agreement, whether express or implied, that any shareholder will not vote his stock or

will vote it only in a specified manner, or that stockholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of voting power will be disregarded." In this case, there was no finding by the Tax Court of any express or implied agreement, either written or oral, regarding the exercise of the voting power possessed by Romney, nor is there any basis in the record for making such a finding.

The regulations state, as another example, that "where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person or persons on whose behalf it is exercised or, if not exercised, will be disregarded" if all of the following facts exist: (a) "the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings;" (b) "the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights;" and (c) "a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957."

Under this three-pronged test Ininco was not a "con-

trolled foreign corporation", since even if we concede the existence of factor "(a)" regarding disproportionate earnings ratios, factors "(b)" and "(c)" were not present. That is, the facts in the record do not indicate that Romney either failed to exercise its voting rights or did not exercise its voting rights independently, nor do they show that avoidance of "controlled foreign corporation" status was a principal purpose for the creation of Inco or its capitalization.

Factor "(b)" was not present because Romney had the right to exercise its voting rights and did in fact exercise them independently. In all respects the voting power possessed by Romney was equal to the voting power possessed by Whitehead and Weiskopf. Further, there is no evidence that Romney agreed or intended not to exercise its vote fully and freely as it saw fit. To the contrary, the evidence demonstrates that Romney fully exercised its vote, appointing two of the four directors of Ininco. Romney was represented at all meetings of the Board of Directors in the persons of Franklin and Goldwater. At these meetings, it freely exercised its voting rights. At Romney's insistence, the Board of Directors required in a resolution that Carr countersign checks in excess of 500 pounds. (App. 110A; Exs. 22-V, App. 216A; 28-BB, App. 226A.) Franklin had high regard for Carr's integrity and felt that this requirement would provide a safeguard for Romney's interest in Ininco. (App. 110A.)

Romney did not take exception to, or become directly

involved in the conduct of Ininco's day-to-day operations. These operations were in large measure conducted from Ininco's office in Holland which was run by an independent agent, Mr. Van Thuijl. (App. 98A, 99A, 157A; Exs. 23-W, App. 219A; 25-Y, App. 221A; 29-CC, App. 228A.)* It is difficult to imagine why Romney would want to be active in Ininco's operations in view of the successful management of Ininco. However, Franklin did consult with the operating officer of Ininco to review its financial affairs. (App. 133A.)

As to factor "(c)", the evidence is clear that the purpose of the existence of Ininco, as well as the nature of its capital structure, was to qualify it as an Overseas Trade Corporation under the United Kingdom law. Under sections 951 through 959 of the Code, Ininco's current earnings would not have been subject to United States income tax, even if Weiskopf and Whitehead owned 100 per cent of its voting stock. The only possible United States tax benefit to them would have arisen on the future sale or liquidation of Ininco. However, as Ininco was intended to be a permanent operation, no such disposition was contemplated. Thus, no finding of United States tax avoidance in this case was made by the Tax Court; indeed, on the basis of the record, no such finding is warranted.

The tests of the regulations are not ends in themselves, but are guides in the evaluation of the facts in each

* In this connection it should be pointed out that the Tax Court erroneously stated that the business of Ininco was operated from the offices of Limited; the Court apparently overlooked the undisputed fact that Ininco maintained its own office in Holland.

case. Here, after giving full effect to the regulations' guidelines, more than 50 percent voting power may not be attributed to Appellants.

The evidence is uncontroverted that both the common shareholder and the preferred shareholder each acquired its respective interest in Ininco to fulfill its own legitimate business purpose and each had every intention of effectively utilizing its respective voting powers whenever and however it saw fit. Romney considered its 50 percent voting power as an essential precondition for making its investment in Ininco, and it exercised its voting power as it saw fit. Accordingly, Romney's voting power cannot be disregarded, and Ininco cannot be considered a "controlled foreign corporation" within the meaning of section 957.

C. Under the Kraus and Garlock decisions, Ininco was not a "controlled foreign corporation".

This Court has dealt with only two cases, Garlock, supra, and Kraus, supra, involving issues arising under the voting power test of section 957. The facts in both cases led the Court to disregard the voting power held by non-United States preferred shareholders. However, the facts in those cases are clearly distinguishable from those of the instant case. Indeed, the views of this Court as expressed in those cases firmly support the Appellants' position that Ininco was not a "controlled foreign corporation".

Kraus case

In Kraus, the taxpayer acquired 100 percent of the outstanding stock of a Liechtenstein corporation. Then he recapitalized the corporation, adding a new class of preferred stock with voting power nominally equal to 50 percent of the corporation's total stockholder voting power. The preferred shares were acquired by eight separate shareholders, whose voting interests in the corporation ranged from 1.5 percent to 22.5 percent. Among the preferred shareholders were an individual who was a close friend of the taxpayer for 40 years, who accounted, directly and indirectly, for 4.5 percent of the voting power, and another of the taxpayer's friends who was also a first cousin of the taxpayer's wife. The cousin was a United States citizen and acquired 9 percent of the voting power.

The directors in office at the time of the transfer of the preferred stock owed their allegiance to the taxpayer and they remained in power until successors were elected. As a result, none of those directors could be dislodged by the preferred stockholders, who could not muster the 51 percent of the votes necessary to elect a director. Accordingly, while the common shareholder had only 50 percent of the voting stock, he always had absolute control of the votes of the Board of Directors.

At the time of the recapitalization, the articles of

incorporation of the corporation were modified to provide that the preferred shares of the corporation could be transferred only with the permission of the Board of Directors and that "such approval may be denied on the basis of important reasons." The articles were also amended to provide that the preferred shares could be redeemed upon three months' notice by the corporation. The common stock was not subject to similar restrictions.

Since the taxpayer always controlled the Board of Directors, there was no real threat of a deadlock vote, and, therefore, no arrangement for breaking a deadlock was necessary. Further, redemption of the dissident stockholders' shares by the Board of Directors provided an easy solution to any potential deadlock problem. The record indicated that the preferred shareholders took no interest in the operations of the company.

Garlock case

In Garlock, as in Kraus, a foreign corporation which was 100 percent owned by a United States shareholder was recapitalized by the addition of voting preferred stock with 50 percent of the stockholder voting power. The taxpayer clearly intended to place the preferred stock with "foreigners who will not have any interest in exercising their vote independently of our 50 percent," 58 T.C. 423, 425 (1972), and who under-

stood its tax avoidance motives and its situation. The recapitalization was effected solely for the purpose of avoiding classification as a "controlled foreign corporation" under section 957.

Prior to issuance of the preferred shares, the taxpayer in Garlock made certain that the voting power attributable to the preferred stock could not be effectively utilized. From the inception, the majority of the Board of Directors were representatives of the taxpayer; under the terms of the articles of association, they served as directors until replaced by a vote of 51 percent of the stock. Thus, while the preferred stockholders had 50 percent of the vote, they were relegated to less than 50 percent representation on the Board of Directors. Further, the common shareholder's control of the Board of Directors enabled it to block any transfer of the preferred shares.

The entire record in the Garlock case showed that there was no practical way for the preferred stockholders to challenge the existing control of the common stockholders. The only possibility might have been by invoking certain arbitration rights. But, since such a procedure would have been costly and time consuming, the Court felt that it was doubtful that such a procedure would ever have been invoked or that effective 50 percent voting power could have been achieved thereby.

Additionally, there was no evidence which indicated any participation, or even an interest, in the company by the owners of the preferred stock, as shareholders or otherwise. To the contrary, the record showed that the preferred stockholders never attended any meetings other than by proxy granted to individuals who represented the common stockholder. Further, since the preferred shareholders had the right, if current asset value or working capital ratios were not maintained at certain designated levels, or in all cases, on 120 days' notice, to require the redemption of their shares at par, they had little reason to be concerned with the corporate management.

This Court's analyses in Garlock and Kraus focused on the question of whether the voting power of the preferred shareholders was "real" and "meaningful." A comparison between those cases and the instant case of the relevant factors shows beyond any doubt that Romney's voting power was real and meaningful and that it cannot be disregarded. The following chart vividly shows this to be true.

Relevant factor	Garlock	Kraus	This case
1. United States tax avoidance was the principal motive for issuing preferred stock with 50 percent of the voting power	yes	yes	NO
2. There was no business purpose for issuing the preferred stock	yes	yes	NO

Relevant factor	Garlock	Kraus	This case
3. The United States shareholders retained majority control of the Board of Directors. The preferred shareholders could not obtain equal representation on the Board of Directors	yes	yes	NO
4. Various restrictions on transferability and redemption were imposed on the preferred shares that were not also imposed on the common shares	yes	yes	NO
5. There was no evidence that the preferred shareholders regarded their voting rights as an essential condition for making the investment	yes	yes	NO
6. The negotiations with the preferred shareholders were not arms-length. Rather, the preferred shares were placed with close friends or relatives or with those who would have no interest in exercising their vote independently	yes	yes	NO
7. There was no evidence that the preferred shareholders were interested in corporate affairs	yes	yes	NO
8. Ownership of the preferred shares was fragmented amongst numerous shareholders so that uniting their vote in opposition to the common shareholder would have been difficult	yes	yes	NO
9. The preferred shares could be redeemed at any time so that they were not a permanent part of the corporate structure	yes	yes	NO

Relevant factor	Garlock	Kraus	This case
10. The preferred stock was created by recapitalizing an existing corporation which had actively been engaged in business and had accumulated substantial earnings	yes	yes	NO

In contrast with the fact pattern in the other decided cases, the record is clear that Romney was not related to or beholden to Appellants, and that it freely and independently exercised its voting rights to protect its interest. Most importantly, Romney considered its 50 percent of Ininco's voting power as an essential condition for making its investment in Ininco. Franklin testified that Romney would not have made the investment in Ininco if it did not receive at least 50 percent of the voting power, because he wanted to be certain that Romney's investment would be protected and that Intapco could not outvote it. (App. 109A.)

Conversely, Appellants intended that Romney have 50 percent of the effective voting power, and they were concerned about their resulting lack of control of Ininco. Despite this concern, and with full appreciation of the legal consequences and their resulting inability to have control of Ininco, Appellants agreed to an equal division of voting power in order to achieve a legitimate business purpose.

It is apparent that the facts in this case are in sharp contrast to the facts in <u>Kraus</u> and <u>Garlock</u>. The conclu-

sion is inescapable that Romney had meaningful ownership of 50 percent of the voting power in Ininco. It is submitted that under the voting power tests of this Court in Kraus and Garlock, it must be determined that Ininco was not a "controlled foreign corporation", and accordingly, section 1248 is not applicable to Appellants' sale of their stock in Intapco.

D. The Tax Court erroneously determined that Ininco was a "controlled foreign corporation".

From a reading of its opinion, it is apparent that the Tax Court has applied the wrong test to the facts of this case in an effort to fit this case into the mold cast by the Second Circuit in Kraus and Garlock. Appellants do not dispute the accuracy of the underlying facts found by the Tax Court. However, because it used the wrong test the Tax Court did not focus on the following undisputed and uncontested key facts which are crucial to this case:

1. Romney would not have invested in Ininco if it had not received equal voting power with Intapco. Franklin testified that he insisted on equal voting rights with Weiskopf and Whitehead as a means to protect Romney's investment. (App. 109A.)

2. Romney could have used its voting power to force a deadlock and thereby collect its 12 1/2 percent dividend

year after year. (App. 127 - 128A.)

3. Romney participated in all corporate meetings and held informal meetings to keep abreast of the financial situation. (Exs. 10-J; 13-M; 14-N; 21-U, App. 213A; 22-V, App. 216A; 23-W, App. 219A; 24-X, App. 220A; 25-Y, App. 221A; 26-Z, App. 222A; 27-AA; App. 225A; App. 133A.)

4. Romney made no agreement, either express or implied, to vote its shares in a specified manner. (App. 57A - 59A, 111A - 112A, 168A - 169A.)

In addition, the Tax Court did not even mention tax avoidance in its opinion. The record in this case is absolutely clear that there was no United States tax avoidance motive in the creation and capitalization of Ininco and that the business purpose for the distribution of voting power was, on the one hand, for Appellants to achieve legitimate deferral of United Kingdom taxes and, on the other hand, for Romney to protect its investment.

The Tax Court's failure to consider these crucial facts and its imposition of an improper economic standard of control are responsible for its clearly erroneous decision in this case. Two themes appear to form the basis of the Tax Court's conclusion that Romney's 50 percent voting rights should be disregarded: (1) Weiskopf and Whitehead, through their ownership of a separate

corporation, controlled the supply of the product line on which Ininco's business was based; and (2) Romney, as a preferred shareholder, had a fixed economic interest in Ininco as compared with the common shareholder's interest.

Reliance on these economic factors is misplaced and, in any event, does not support the conclusion that Romney's voting power was not real and meaningful. Notions of economic control have no place in determining whether Ininco was a "controlled foreign corporation" either under the statute, the Treasury regulations, or this Court's opinions on the matter. The test is solely one of voting control.

The Tax Court begins its analysis of this case with a reference to the following language from this Court's opinion in Garlock as being applicable to this case:

> "'[it] is significant also that the terms of the arrangement worked out were such that the preferred shareholders would have no interest in disturbing the taxpayer's continued control.'"

In applying this concept to this case, the Tax Court argues first that Romney was given an attractive dividend rate on its investment. Appellants do not understand what implication Romney's dividend rate has regarding the question of real voting power. It is curious that Romney's economic incentive for making the investment in Ininco in the first place and for maintaining this investment over a long term is somehow twisted around to support a totally unrelated conclusion.

Further, the Tax Court fails to take into account the fact that Romney's rate of dividend on its shares was negotiated at arms' length.

The Tax Court then states that Romney had a limited stake in Ininco's business, because, as a preferred shareholder, Romney could expect to receive only a return of its investment (the par value of its shares) whether it attempted to sell its interest or forced a liquidation of Ininco. Of course, it is the very nature of preferred stock that, unlike common stock, it does not share in the appreciation of a corporation; its interest in the corporate capital is fixed. However, this fact has no bearing whatsoever on the question of whether a class of stock has voting power. Romney had an economic investment to protect, even if it was fixed. It also had an attractive dividend yield to protect. There is nothing in the fixed nature of its capital investment or dividend yield which limits the free exercise of its 50 percent voting rights to protect its interest.

The Tax Court misunderstood what this Court was saying in the passage quoted from Garlock. In Garlock, this Court was faced with the following combination of factors: the preferred shareholders had a minority position on the Board of Directors, and they could demand to be redeemed on three months notice or whenever working capital fell below specified levels. Accordingly, the preferred shareholders could not have exercised

equal voting rights on the Board of Directors, except, perhaps, if they instituted costly litigation proceedings to invoke certain arbitration rights. This Court felt it was unlikely that they would do so in view of their fixed interest in the corporate capital and their option to demand to be redeemed at any time. The passage quoted above reflects this combination of factors.

In its opinions in Kraus and Garlock this Court expressed concern that the preferred shareholder with a fixed dividend right and fixed investment in the capital might not have cared enough to fight the common shareholder's existing majority control of the Board of Directors, but would have allowed its shares to be bought out. In sharp contrast, Romney always had equal voting power on the Board of Directors and simply had to cast its 50 percent vote in order to create a deadlock. There was no "existing control" which Romney had to "disturb"; on the contrary, there was equality of votes on the Board of Directors at all times, and Romney could have voted for a deadlock at any time. Accordingly, the passage from Garlock quoted by the Tax Court is not applicable to this case.

The Tax Court states that a "factor which indicates that Whitehead and Weiskopf retained control and dominion over Ininco despite Romney's 50 percent voting rights was retention of complete and unfettered control by Limited over Ininco's only product line, the AutoAnalyzer." (Emphasis supplied.) In essence, the Tax Court seems to be saying that by terminating

supply of the product, Whitehead and Weiskopf could end Ininco's existence. However, even if Limited had unilaterally stopped selling AutoAnalyzers to Ininco, Ininco would have retained the capital it had already accumulated and its existence would not have been jeopardized. By March, 1966 Ininco had accumulated capital of more than two million dollars. Romney's real voting power enabled it to protect its investment of $70,000 in Ininco and the right to a 12-1/2 percent annual dividend. If it had wished, it could have refused to sell its shares in Ininco, and, in effect, forced Appellants to keep Ininco alive, in which case Romney would have continued to receive its 12-1/2 percent dividend.

The Tax Court's misdirected attempt to link control of the product line with voting power is epitomized by the following statement in its opinion:

> "Although we find it difficult to believe that a party with 50 percent of the voting power of a corporation would enter into an arrangement in which its only product line could be withdrawn at any time by action of the remaining 50 percent shareholders, we do not foreclose the possibility that such an arrangement might be entered into at arms-length. When, however, these circumstances are present in conjunction with other factors indicating that dominion and control are possessed by United States shareholders, the control which Whitehead and Weiskopf maintained over the continued supply of the AutoAnalyzer becomes a significant factor."

The Tax Court's view of how business is conducted

is somewhat naive. Thousands of dealers and other entrepreneurs depend upon unrelated outside suppliers for the continued operation of their business. They cannot exercise control over such outside suppliers. Their power extends only to the control they have over their own business. As Franklin pointed out in his testimony, he was not at all concerned with Autoanalyzers. He was concerned only with protecting Romney's investment in Ininco. (App. 141A.) Since Ininco had little fixed investment in that product, the risk that the supply might be cut off did not jeopardize Romney's investment.

Indeed, Romney's position as a preferred shareholder made Appellants' potential economic threat of cutting off the product supply of little significance. Where there are two shareholders each with 50 percent of the corporate voting power, one shareholder's control over the supply of the product may give it the economic power to affect the other shareholder's possibility of future appreciation and consequently may result in some influence over how the other shareholder exercises its voting power. However, in the instant case, since Romney did not share in future appreciation and since its investment and its dividend were safe for years to come due to its preferred position as to the original capital and the accumulated earnings of the corporation, it was free

of any economic exertion caused by control of the product line.

Moreover, the Tax Court concedes that this economic factor is significant only if it is present in conjunction with other factors indicating dominion and control. Yet, on analysis, it does not point to any other factors showing dominion and control. The point simply is that the power to control supply could not prevent Romney from freely and fully exercising its voting rights in Ininco.

The Tax Court refers to the deadlock and arbitration factors in an attempt to equate this case with Garlock and justify its conclusion that Ininco was a "controlled foreign corporation". However, the Tax Court entirely misconstrues the significance of those factors. Appellants have made the point that Ininco was created as a "deadlock" company in an effort to demonstrate the exact equality of voting power between Romney and Intapco at the shareholder level and on the Board of Directors. The Shareholders' Agreement does not provide for arbitration to resolve unagreed upon corporate matters, but rather it provides for arbitration in case of differing interpretations of the Agreement.

In Garlock, where the United States shareholder con-

trolled a majority of the Board of Directors, the taxpayer contended that its majority representation on the Board of Directors was not determinative because the foreign shareholders had 50 percent of the voting power on the shareholder level, and, under an arbitration provision which applied, they could have prevented the United States-shareholder-controlled Board of Directors from taking action contrary to the interest of the foreign shareholders. The taxpayer in Garlock relied on the arbitration provision as a means to enhance the voting power of the foreign shareholders to make it equal to its voting power. The Court felt, however, that the invocation of that provision by the preferred shareholders was unlikely, in view of their limited economic interest in the company and their right of redemption.

In contrast, there was at all times equal representation on the Board of Directors of Ininco between Appellants and Romney; the arbitration provision was not needed to create such equality. Appellants do not contend that an arbitration provision, which related only to resolving questions of interpretation arising under the Shareholders' Agreement, was designed to break a deadlock vote of Ininco. Nor do they contend that this provision particularly enhanced either Romney's or Intapco's voting rights. The voting power of Romney and Intapco was equal regardless of any arbitration clause, and the arbitration clause, therefore, is not relevant in this regard.

The Tax Court's analysis overlooks the importance of Romney's ability to deadlock the vote. Romney was in the business of making investments. When it first invested in Ininco, it was taking what it considered a significant risk, investing $70,000 in a new corporation which was going to sell a relatively unknown product manufactured by a very small United Kingdom corporation. For its risk it demanded a substantial return of 12 1/2 percent which was higher than the going rate of return on less risky investments and substantially higher than the 8 or 9 percent dividend initially offered to it by Appellants. After Ininco proved to be a profitable operation, Romney's investment became fairly secure and its 12 1/2 percent dividend was assured for many years. As Franklin's testimony indicates, Romney could, if it chose, have taken no action to break the deadlock and sat back and collected its annual 12 1/2 percent dividend year after year. Franklin testified that if there were an evenly divided vote, and Romney's interest in Ininco were not jeopardized, Romney might do nothing and allow the deadlock to continue. (App. 127A - 128A.)

Since there was no provision which gave the common shareholder the ability to redeem Romney's shares and resolve the deadlock (as there was in <u>Kraus</u>), Appellants were in fact locked in. If Romney chose to halt the corporate process, it could do so, and all of the earnings of Ininco would have re-

mained in the corporation. Whitehead testified that in considering whether to share 50-50 voting power with Romney, he was concerned about the possibility that Romney might tie up the capital. (App. 56A - 57A.)

Also, Romney, as a subsidiary of a publicly held mutual investment company, was under a fiduciary duty to the public shareholders to protect its investment in Ininco. (App. 112A.) Thus, if Whitehead and Weiskopf attempted to dissipate the earnings of the corporation (e.g., by too rapid expansion or by attempting to declare excessive dividends to the common shareholders, thereby jeopardizing the preferred dividend), Romney would have been obliged to act. Romney, therefore could have exercised its voting power and, contrary to what the Tax Court appears to believe, had very real incentives to exercise its 50 percent voting power to further its own interests.

The Tax Court apparently does not understand the ramifications of the fact that both Romney and Intapco were subject to the same requirement that their shares be offered first to the other shareholders. The Tax Court again injects the notion of economic control of the supply and says that "as a practical matter, the provisions of the Articles of Association and the Shareholders' Agreement ensured that Romney had no real interest in disturbing control of Ininco, as it could only obtain a return on its investment no matter which method it followed." However, the right of first offer neither enhances nor detracts from the

right of the shareholder to exercise its voting power. Further, whether or not the right of first offer was present has no effect on either shareholder's "incentive" to protect its investment or to exercise its voting power.

Most importantly, the detrimental consequences to Appellants of either shareholder implementing the procedures set forth in the Shareholders' Agreement gave Romney a powerful economic weapon. The Tax Court alludes to this power, but ignores its importance, emphasizing instead Romney's fixed capital and dividend interest. Intapco could invoke its right to call for a liquidation only at great financial sacrifice, since the value of its shares on a liquidation was reduced 40 percent by the applicable United Kingdom tax. This tax represented the United Kingdom "income" tax which was previously deferred on account of Ininco's Overseas Trade Corporation status. Nor could Intapco sell its shares without financial sacrifice, if Romney refused to purchase them. In the first place, under paragraphs 4(b) and 6(a) of the Shareholders' Agreement the price at which the shares had to be offered to Romney (i.e., the "prescribed price" as defined in paragraph 5 of the Shareholders' Agreement) was their liquidation value; the value of the shares on liquidation as reduced by the 40 percent tax. In the second place, it is unlikely that an outside purchaser would have been willing to purchase Intapco's shares without a substantial

discount because an unrelated third party (Romney) owned 50 percent of the voting power. Finally, a sale or liquidation would have abruptly ended the Overseas Trade Corporation benefits on future sales of AutoAnalyzers, disrupted Ininco's business operations and forced Appellants to reorganize during a period of expanding sales.

On the other hand, if Romney had offered to sell its shares, Intapco would have been in a difficult predicament. If it purchased Romney's shares it would own 100 percent of Ininco and would thereby lose the Overseas Trade Corporation benefits on account of the surtax direction provisions. If it refused to purchase the shares, Romney could (1) force a liquidation which would trigger the 40 percent United Kingdom tax on accumulated earnings, and terminate the Overseas Trade Corporation benefits on future sales, or (2) sell its shares to an outsider which might not qualify as a proper shareholder for purposes of the Overseas Trade Corporation benefits. Accordingly, Romney had a powerful economic weapon in the first right offer and Appellants had only a detriment.

Perhaps the most glaring example of the Tax Court's attempt to fit this case into the mold of Kraus and Garlock is found in the following statement of the Tax Court:

> "It defies credulity that Romney would have advanced more money than Intapco and received only 12 1/2 percent of the dividends to be paid by a company that was to be exempt from United Kingdom

taxes on its profits if it truly obtained 50 percent of the voting power of that company."

The key phrase "It defies credulity" appears in the Court's opinion in Kraus at 490 F.2d at 902, and in using it the Tax Court has taken the language of this Court and tried to apply the concept of this Court, but has created a non sequitur.

The Tax Court apparently is saying that it is fundamentally inconsistent for a shareholder who puts up more than one-half the original capital to receive a fixed capital and dividend interest and one-half or more of the voting power. However, voting power cannot be equated with equity interest. The point that the Tax Court has missed is that the voting power which Romney had was intended to provide additional security for the capital it contributed, as opposed to being a vehicle for it to share equally in all potential corporate profits.

Ininco was a newly formed corporation with initial capital of 45,000 pounds of which 25,000 pounds (more than half) was contributed by Romney, for which it received 50 percent of the voting power, and 20,000 pounds was contributed by Intapco, for which it received the remaining 50 percent of the voting power. It certainly does not defy credulity that Romney wanted and received equal voting power as a means to protect its investment.

Further, Appellants' business reasons for entering into the transaction are clear. If Ininco had not been

formed, the profits on the selling function would have been taxed by the United Kingdom at the usual corporate rate, and the amount of capital which would have been available to finance the increased sale of AutoAnalyzers would thereby have been reduced significantly. For example, if Ininco earned $1,000,000 before taxes, and it did not qualify as an Overseas Trade Corporation, the net income remaining after applying the 40 percent United Kingdom income tax rate would have been approximately $600,000. Appellants would then have been in the position of having total control over $600,000 on capital to be used for expanding sales of AutoAnalyzers. On the other hand, by organizing an Overseas Trade Corporation and qualifying for tax deferral benefits, Appellants could have benefitted from the use of $1,000,000 to expand sales of AutoAnalyzers. However, in order to obtain the use of this increased capital it was necessary to give up voting control. Whitehead testified that he had many reservations about giving up voting control and that he was reluctant to do so. He testified that it was a matter of deciding whether the benefits of Overseas Trade Corporation status outweighed the detriments of having an equal partner and the attendant risk that the capital might be tied up. He decided to give up voting control in order to obtain the use of the additional capital to finance increased sales of AutoAnalyzers. Whitehead testified that this was a basic part of Appellants' over-all business strategy. (App. 56A - 57A.)

Clearly, therefore, it does not defy credulity that Appellants would have given Romney 50 percent of the voting power of Ininco. This decision was a perfectly reasonable business-motivated action designed to help finance the growth of manufacturing and sales.

The Tax Court states that the manner in which Ininco was wound up confirms the control and domination of Whitehead and Weiskopf. However, the Tax Court again points to control of the supply and twists the interpretation of the facts to fit within its erroneous conclusions. The facts are that after being advised by their solicitor, Robert Carr, of the repeal of the Overseas Trade Corporation provisions, Whitehead and Weiskopf decided to follow Carr's advice that they dispose of their interest in Ininco. Carr worked out a plan for the sale of the stock of Intapco to Hong Kong Holdings. Carr then contacted Franklin in December, 1965, and advised him of Whitehead's and Weiskopf's desire, and asked if Romney would agree to sell its shares in Ininco.

As the record indicates, Franklin was at first indignant at Carr's suggestion and objected because Romney's investment in Ininco was to have been a long term investment. (App. 113A.) However, upon reflection, Franklin understood that the business reason for the requested disposition was the repeal of the Overseas Trade Corporation law, and he decided that Romney

should not offer an impediment to the sale of the Ininco shares. Romney, therefore, agreed to sell its Ininco shares. Significantly, Romney negotiated for and received a premium over and above what it would have been entitled to receive on liquidation, in exchange for its cooperation in giving up what had been conceived of as a long term investment.

Carr then concluded negotiations for the sale of both the common and preferred shares in Ininco to Hong Kong Holdings. On February 21, 1966, Weiskopf and Whitehead sold their shares in Intapco to Hong Kong Holdings pursuant to an agreement executed on that date. Thus, Weiskopf and Whitehead consulted with Romney at least two months before the agreement was entered into with Hong Kong Holdings. It would have made no business sense for Whitehead and Weiskopf to secure Romney's consent before consulting with Hong Kong Holdings, since one first has to have formulated a transaction before one can ask another shareholder to agree to it.

The Tax Court incorrectly says that "Romney's limited rights under the Shareholders' Agreement were ignored." Yet the Tax Court does not point to any rights which were ignored. After consultation, the shareholders both agreed not to exercise their respective rights of first refusal under the Shareholders' Agreement, but rather to sell their shares to an outsider.

The Tax Court also states that "Romney had no viable alternative but to sell its interest in Ininco to the buyer which Carr had located," once again citing Appellants' control over the

product line, and once again overlooking Romney's very real ability to force a deadlock and sit back and collect its 12 1/2 percent return year after year.

If, as the Tax Court points out, Romney "lacked any real or meaningful power to influence decisions affecting the future of Ininco or its business", why did Appellants consult Romney at all? Why was Romney paid a premium for its shares? Why didn't Appellants just go ahead and do what they wanted? Further, if Romney's voting rights were meaningless, why did Hong Kong Holdings insist upon acquiring Romney's shares in Ininco as well as Intapco's? The answer is clear; Romney had real and meaningful 50 percent voting power in Ininco.

The Tax Court points to "an examination of the overall transaction" as establishing Appellants' dominion and control, because the purpose for creating Ininco was to benefit Technicon and help it expand worldwide sales of AutoAnalyzers. Of course, Ininco benefited Technicon, but it also benefited Romney. Merely because the operation was beneficial to Whitehead and Weiskopf does not mean it was *ipso facto* adverse to the interests of Romney. Romney's investment in Ininco was conceived to serve Romney's own objectives. It does not follow that Romney's interest and Technicon's interest were conflicting. The successful operation of Ininco in no way inured to the detriment of Romney. Romney would not object to practices which increased the profits

of Ininco and thereby increased the security of its investment; rather, it would approve of them. Surely it is not necessary to show that Romney interfered with the successful operations of Ininco. Significantly, it was shown that Romney was involved in Ininco's financial operations, and participated fully in the Board of Directors.

In an effort to give the appearance of conforming to this Court's guidelines as set forth in Kraus and Garlock, the Tax Court has twisted some of the relevant concepts, and misapplied an erroneous economic test by using a contorted and strained analysis that simply does not withstand a close look. The factors showing voting control which were present in those cases simply are not present here. The Tax Court's conclusion is not based on the proper legal standards, but rather on improper application of an economic standard. While, of course, Whitehead and Weiskopf had a potentially greater economic interest in Ininco than Romney and control of Ininco's product line, the question which must be answered is whether Romney had real and meaningful voting power in Ininco.

The Tax Court has approached the voting power question only from the viewpoint of what Appellants were seeking to accomplish. It has not fully considered that Romney also had investment objectives and that it believed it had real and meaningful voting power in furtherance of those objectives. Romney, which knew of Appellants' control of the product line, would not have made its investment unless it had an equal vote

in Ininco. This enabled Romney to be in a position to counter any control Appellants may have had over the product line by enabling Romney to force a deadlock and thereby tie up the capital of the corporation. Thus, viewed in proper perspective, Appellants' control of the supply did not vitiate Romney's voting power.

The Tax Court's decision in this case should be read alongside another Tax Court case decided by the same Tax Court judge less than one month after his decision in this case. CCA, Inc., 64 T.C. 137 (1975). Although Judge Wiles found that the taxpayer in CCA, Inc. divested itself of 50 percent of its voting power in an existing corporation solely for tax avoidance purposes in order to avoid classification as a "controlled foreign corporation", his opinion goes on to enumerate the factors which indicate that the taxpayer had divested itself of dominion and control.

> "There were no substantial restrictions placed upon the preferred stock that were not also placed upon the common stock. Nor were there any provisions made whereby old CCA would reacquire the stock of the preferred shareholders should they desire to sell the stock. Furthermore, a board of directors that was equally divided between preferred and common shareholders was established and the members of that board were given very significant powers which could have been used by both the common and the preferred shareholders to alter the course of events of the corporation. The preferred stock was sold to nonrelated shareholders whose representatives at the shareholders meetings and the board of di-

> rectors took an active part in the considerations of AG's business. Old CCA retained no significant strings which could have been used by it to require the preferred shareholders to vote with it regarding questions of AG's business."

As discussed herein, these same factors are also present in the instant case and yet, in this case, they are ignored in favor of an economic standard which is improperly applied.

It is submitted that the Tax Court did not apply a proper legal standard in this case, and that its finding that Ininco was a "controlled foreign corporation" was clearly erroneous.

Point II

The Tax Court Erroneously Disregarded the Sale by Whitehead and Weiskopf of Their Intapco Stock and Treated the Transaction As a Liquidation of Ininco.

Section 1248(b) sets forth various rules which limit the amount of federal income tax applicable to the gain on the sale of stock in a controlled foreign corporation. These rules, which are elaborately set forth in Treasury regulations, are quite complicated in their detail. Simply stated, the concept they attempt to effectuate is to limit the tax on the gain to federal income tax which would have been paid at the corporate and shareholder levels had the foreign corporation been subject to United States income tax during the period it was owned by the taxpayer.

After erroneously determining that Ininco was a controlled foreign corporation, the Tax Court also erroneously determined that Weiskopf and Whitehead should be treated as having liquidated Ininco, thereby disregarding their sale of stock in Intapco and the liquidation of Ininco by an unrelated third party. In so doing, the Tax Court, in effect, treats Weiskopf and Whitehead as the owners of Ininco during the period from February 21, 1966, when they sold their stock in Intapco, to May 3, 1966, when Hong Kong Holdings dissolved Ininco.

The Tax Court disregards the undisputed facts that Hong Kong Holdings (1) was totally unrelated to Weiskopf and Whitehead, (2) became the sole shareholder of Ininco with total control of that corporation by purchasing the shares of Ininco owned by Intapco and Romney on February 21, 1966, (3) unilaterally conducted the affairs of Ininco from February 21, 1966 to May 3, 1966 and (4) received the approval of Inland Revenue of the United Kingdom (a) to be treated as the sole beneficial owner of all of Ininco's stock and (b) to receive dividends from Ininco free of the 40 percent tax which would have applied had Intapco been considered the owner of the common stock.

Accordingly, the Tax Court's disregard of the sale by Weiskopf and Whitehead of their shares in Intapco is erroneous, and the determination of Appellants' federal income

tax liability under section 1248(b) must be recomputed accordingly.

CONCLUSION

It is respectfully submitted that the decision of the Tax Court should be reversed and judgment entered in favor of the Appellants.

Respectfully submitted,

Roberts & Holland
Attorneys for Appellants

Of Counsel:

Laurence Goldfein
Mark H. Johnson
Richard A. Levine
Lary S. Wolf

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

EDWIN C. WHITEHEAD and JOSEPHINE WHITEHEAD, Appellants v. COMMISSIONER OF INTERNAL REVENUE, Appellee	)	No. 75-4227

CERTIFICATE OF SERVICE

It is hereby certified that service of two copies of the Appellants Brief in the above entitled case has been made on counsel for the Appellee on this 26th day of March, 1976, by mailing a copy thereof in an envelope, with postage prepaid, addressed to Scott P. Crampton, Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20530, attention Jeffrey S. Blum, Esq.

Dated: March 26, 1976

Laurence Goldfein

Laurence Goldfein